**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS: 01-0188; 01-0190**
**Indiana Corporate Income Tax**
**For the Years 1991 through 1998**

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## ISSUES

**I. Taxpayer Holding Company Acting in an Agency Capacity – Gross Income Tax**.

**Authority**: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999); Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994); Universal Group Ltd v. Indiana Department of Revenue, 609 N.E.2d 48 (Ind. Tax. Ct. 1993); 45 IAC 1-1-54; 45 IAC 1-1-54(2).

Taxpayer holding company argues that it is not subject to Indiana's gross income tax scheme.

**II. Sale of Real Property – Deduction for Encumbrance Secured by the Real Property**.

**Authority**: IC 6-2.1-3-16; IC 6-8.1-5-1(b); 45 IAC 1-1-110; 45 IAC 1-1-147; 45 IAC 1-1-148.

Taxpayer operating company maintains that the amount of proceeds derived from the sale of its Indiana real property should be reduced by the amount of those proceeds which were used to pay down the encumbrance held against that real property.

**III. Abatement of the Ten-Percent Negligence Penalty**.

**Authority**: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that it is entitled to an abatement of the ten-percent negligence penalty.

## STATEMENT OF FACTS

This Letter of Findings addresses a joint protest filed by two closely related, out-of-state companies. Hereinafter, the companies are designated as taxpayer holding company and taxpayer operating company.

Taxpayer operating company operates three restaurants in Indiana under various trade names. Taxpayer operating company has no other Indiana business activities other than the restaurant operations.

Taxpayer holding company holds real estate and personal property used by taxpayer operating company. The real estate and personal property is used in the operation of the three Indiana restaurants. Taxpayer holding company was incorporated in 1969 for the purpose of holding the various restaurant properties including the property located within Indiana.

The officers and directors of the two companies are identical. According to taxpayer's representative, taxpayer holding company is a "shell corporation" created entirely for the purpose of allowing taxpayer holding company to obtain advantageous "single asset" financing.

In the audit of the two entities, it was determined that taxpayer holding company was a "non-filer" receiving Indiana source income. Therefore, the audit determined that taxpayer holding company was subject to the state's corporate income tax scheme and assessed taxes accordingly.

Both entities submitted a joint protest of the audit's determinations. An administrative hearing was held, and this Letter of Findings follows.

## DISCUSSION

### I. Taxpayer Holding Company Acting in an Agency Capacity – Gross Income Tax.

Taxpayer holding company owns property in Indiana which is used by taxpayer operating company in its restaurant businesses. Taxpayer holding company receives income from personal property through a reimbursement of depreciation expense on that personal property. For example, taxpayer holding company may hold $1,000 in personal property located within the state. At the end of the year, if the property depreciates in value to $900, a "book" transfer of $100 is made to taxpayer holding company's side of the general ledger to compensate for that depreciation.

In addition, the audit determined that taxpayer holding company receives lease income on certain of the real property located within the state.

During the 1996 tax year, taxpayer holding company sold two of its Indiana real properties. The audit held that the proceeds from the sale of this real property constituted taxable gross income.

Taxpayer holding company maintains that it did not have Indiana gross income separately identifiable from the gross income of taxpayer operating company because taxpayer holding company is simply a "shell" corporation having no separate identity outside that of taxpayer operating company.

Both taxpayers have the identical officers and directors. Taxpayer holding company does not maintain a separate general ledger or other separate books of account. Taxpayer holding company does not have a separate bank account, maintains no separate cash reserve, no accounts receivable, and no trade payables. Taxpayer holding company's financial statement is derived from the taxpayer operating company's general ledger and is prepared in order to fulfill its federal and state tax obligations. Taxpayer holding company does not have any employees.

Essentially, taxpayer holding company maintains that it is an agent for taxpayer operating company.

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary of Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indian – such as taxpayer holding company – the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2).

However, 45 IAC 1-1-54 exempts that portion of a taxpayer's income which the taxpayer receives while acting in an agency capacity. The regulation states:

> Taxpayers are not subject to gross income tax on income they receive in an agency capacity. However, before a taxpayer may deduct such income in computing his taxable gross receipts, he must meet two (2) requirements:
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>> (1) The taxpayer must be a true agent. Agency is a relationship which results from the manifestation of consent by one person to another authorizing the other to act on his behalf and subject to his complete control, and consent by the other to so act. Agency may be established by oral or written contract, or may be implied from the conduct of the parties. However, the representation of one party that he is an agent of another without a manifestation of consent by the alleged principal is insufficient to establish an agency. Both parties must intend to act in such a relationship.
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>> Characteristic of agency is the principal's right to complete and continuous control over the acts of the agent throughout the entire performance of the contract. This right to control cannot be limited to the accomplishment of a desired result. In addition, the principal must be liable for the authorized acts of the agent.
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>> (2) The agent must have no right, title, or interest in the money or property received or transferred as an agent. In other words, the income received for work done or services performed on behalf of a principal must pass intact to the principal or a third party; the agent is merely a conduit though which the funds pass. A contractual relationship whereby one person incurs expense under an agreement to be reimbursed by another is not an agency relationship unless the other elements of agency exist, particularly the element of control discussed above. Where tangible personal property is purchased by an agent for a principal, title need not vest immediately in the principal in order for the agent's reimbursement to be deductible if there is an agreement between the parties authorizing one to purchase on behalf of other. However, income derived from

> sales by the principal and subsequent resale by the agent to customer is subject to gross income tax.

The Indiana Tax Court in Policy Management Systems Corp. v Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999) and Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994) reviewed the relationship between the imposition of the state's gross income tax and agency principles, echoed the regulatory standards set out in 45 IAC 1-1-54, and found that an agency relationship required consent by the principal, acceptance and authority by the agent, and control of the agent by the principal.

Taxpayer holding company does not elude the otherwise inclusive language of IC 6-2.1-2-2(a)(2) because it is not standing in a true agency relationship with taxpayer operating company. Both taxpayers regard the book entries in favor of taxpayer holding company as a mere technical and wholly transparent transfer of funds designed simply to serve the mutually beneficial interest of both parties. Taxpayers may be correct in that initial assertion; nonetheless, the parties' relationship does not possess the hallmarks of a true agency relationship because taxpayers mistakenly equate transparency with agency.

An agency relationship is marked by linear transactions between third-party, agent, and principal whereby the agent acts merely as the conduit between the third-party and principal because the agent is, at all times, under the control of the principal and because the agent never has any beneficial interest in the transactions. The circular relationship between taxpayer holding company and taxpayer operating company is not that of agent and principal because "[t]o be outside the gross income tax, there must be both agency and *pass through*, actual or substantive." Universal Group, 642 N.E.2d at 557 (*Emphasis added*).

Taxpayers' argument also fails by virtue of the language contained in 45 IAC 1-1-54(2) which states that "[t]he agent must have no right, title, or interest in the money or property received or transferred as an agent." The cases interpreting that provision have consistently held that "reimbursements of a taxpayer's own expenses are receipts of gross income to the taxpayer." Universal Group Ltd v. Indiana Department of Revenue, 609 N.E.2d 48, 54 (Ind. Tax. Ct. 1993); Policy Management, 720 N.E.2d at 23.

Taxpayer holding company was reimbursed for the depreciation expense it incurred on personal property it owned in Indiana. Although those reimbursements may have consisted of nothing more than "book entries," nonetheless, the reimbursements were intended to compensate taxpayer holding company for its *own* depreciation expenses and not the expenses incurred by taxpayer operating company.

In addition, taxpayer holding company received rental income from real property held within the state. Taxpayer holding company received that rental income by virtue of the fact that it – not taxpayer operating company – owned the real property. If taxpayer operating company owned the real property and taxpayer holding company was merely a disinterested agent collecting rents on behalf of taxpayer operating company, taxpayers' argument would have merit. Such is not the case, and taxpayers' argument must fail.

In addition, taxpayer holding company sold certain of its real property during 1996. The income attributable to the sale of the real property was, for purposes of the gross income tax, directly attributable to taxpayer holding company. The real property did not belong to taxpayer operating company. Taxpayer holding company was not merely acting as a disinterested agent on behalf of taxpayer operating company when it sold the property. Again, taxpayers' agency argument fails.

**FINDING**

Taxpayer's protest is respectfully denied.

**II. Sale of Real Property – Deduction for Encumbrance Secured by the Real Property.**

The audit determined that taxpayer holding company sold two of its Indiana properties during 1996. The gross receipts from the sale of those assets were included for gross income tax purposes. The audit did not allow a deduction for payment of outstanding debt on the property because "no documentation was provided showing this allocated debt was a mortgage on the sold property."

Taxpayer holding company argues that the proceeds from the sale of the Indiana real property should be reduced by the amount used to "pay down" the encumbrances on that real property. To that end, taxpayer holding company has provided documentation which it maintains is sufficient to justify the deduction.

IC 6-2.1-3-16 exempts certain proceeds from the sale real property from gross income tax.

> (a) Except as provided in subsection (b), amounts received from sales of real estate are exempt from gross income tax to the extent of any mortgage or similar encumbrance that exists on the real estate at the time of its sale.
>
> (b) The exemption provided by this section does not apply to any mortgage or encumbrance created for the purpose of avoiding gross income tax liability.

The regulation, 45 IAC 1-1-110 restates the same principal:

> Real Property Sales: Gross income tax is imposed at the higher rate on the proceeds from the sale of an interest in real estate. In computing the proceeds from real estate sales for gross income tax purposes, the value of any mortgage (unless created for the purpose of avoiding the tax) may be deducted.

The regulations provided that it is not necessary that the entire encumbrance be paid. However, the exemption is then limited to the percentage that the cost of the real estate sold bears to the total cost of all the real estate covered. Specifically, 45 IAC 1-1-147 provides as follows:

> Mortgages on Real Estate. Mortgages and similar encumbrances existing upon real estate at the time of its sale are not part of the taxable consideration derived from the sale. This is true whether or not the encumbrance is paid off upon sale, is assumed by the purchaser, or the property is transferred subject to the encumbrance. The deduction under this section of the Act *[IC 6-2.1]* is limited to the principal amount of the mortgage and not the interest thereof.

Although the taxpayer may meet all the preceding qualifications, nonetheless, “Mortgages and encumbrances created upon real estate for the purpose of avoiding gross income tax are not excluded from taxation.” 45 IAC 1-1-148.

In 1993 taxpayer operating company borrowed a substantial sum described by the parties as “Senior Notes.” These Senior Notes were secured by all of taxpayer operating company’s assets and by all of taxpayer holding company’s assets. In addition, both taxpayer operating company and taxpayer holding company guaranteed the Senior Notes and collateralized that guarantee with all of taxpayer holding company and taxpayer operating company’s assets. The assets used to secure the Senior Notes included the Indiana real properties sold in 1996.

Taxpayers have provided a copy of the original 1993 Offering Memorandum. This document indicates that the Senior Notes would be secured by “substantially all of the assets of [taxpayer operating company] and [taxpayer holding company].” The 1993 Offering Memorandum restricted the ability of taxpayer operating company and taxpayer holding company to sell any of their assets. The Offering Memorandum required that any proceeds from the sale of taxpayer operating company and taxpayer holding company’s assets would be used to repurchase the Senior Notes *unless* those proceeds were used to reinvest in similar assets. In such an instance, those “similar assets” would become substitute collateral for the Senior Notes.

Taxpayers have provided a copy of their “Report of Independent Public Accountants” for the year ending December 27, 1993 and dated March 2, 1994. Information regarding the Senior Notes is found on page F-11 of that report. The report states that, “Substantially all assets of the [taxpayer operating company] are pledged to its senior lenders. In addition, the [taxpayer holding company has] guaranteed the indebtedness owed by the [taxpayer operating company] and such guarantee is secured by substantially all of the assets of the [taxpayer holding company].”

In 1996, taxpayer operating company and taxpayer holding company completed a sale/leaseback transaction which included the Indiana real properties. Of the total amount derived from that transaction, approximately 66 percent was used to repay the principal on the Senior Notes. Taxpayers have provided documentation regarding the properties sold, substantiating the sales prices of the properties, and describing the manner in which proceeds were distributed.

Taxpayers have met its burden of proof – imposed under IC 6-8.1-5-1(b) – of demonstrating that they are entitled to claim the gross income tax deduction provided in IC 6-2.1-3-16. The Senior Notes were secured by taxpayer operating company and taxpayer holding company’s assets. Those assets included the Indiana real estate sold during the 1996 tax year. In the event of a default on the Senior Notes, the lender had the right to seize the Indiana real estate. A verifiable portion of the proceeds from the sale of the Indiana real estate was used to repay the principal on the Senior Notes. Finally, there is no indication that either taxpayer entered into the Senior Note agreement for the purpose of avoiding the state's gross income tax.

**FINDING**

Taxpayer's protest is sustained.

## III. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer maintains it is entitled to abatement of the ten-percent negligence penalty assessed at the time of the original audit.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer argues that it had a reasonable basis for concluding that taxpayer holding company's revenues were not subject to the state's gross income tax. In addition, taxpayer asserts that it timely, fully, and accurately reported the financial activities relating to the relationship between taxpayer operating company and taxpayer holding company.

Taxpayer has met its burden of demonstrating that its failure to pay the gross income tax deficiency was based upon "reasonable cause and not due to willful neglect." IC 6-8.1-10-2.1(d).

**FINDING**

Taxpayer's protest is sustained.

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